

## Mutual Fund Giant Vanguard Flexes Its Muscles

The index-investing pioneer now has \$3.8 trillion in assets. How will it use the clout that comes with all that money?

The question made him uncomfortable. And suddenly he was getting it from all directions. In the fall of 2010, Vanguard CEO Frederick William “Bill” McNabb III found himself fielding the same query over and over again: “What does it feel like to be No. 1?”

It was only natural that people should ask. That year Vanguard, the low-drama, low-cost index shop headquartered outside Philadelphia in Malvern, Pa., was in the process of sucking up some \$80 billion in new assets—the most of any fund company for a second straight year. In September, Vanguard had surged ahead of longtime industry leader Fidelity to become the world’s largest mutual fund manager. Like it or not, Vanguard was on top.

As McNabb saw it, Vanguard’s ascendance was a wonderful thing for investors—a milestone in bringing low-fee money management to the masses. But for the company itself he wasn’t as sure. McNabb decided he needed to share his thoughts. So he penned a letter to his 12,700-strong “crew”—Vanguard is named for an 18th-century ship, and nautical terms abound there—and posted it internally, on Dec. 15, 2010, to “Bill’s Blog.”

The message, titled “The Penalty of Leadership,” was hardly imbued with holiday cheer or the faintest wiggle of victory dance. Rather, McNabb admitted that Vanguard’s top-dog status “unsettled” him. He warned that the firm’s hard-won reputation could be destroyed by a single mistake and that Vanguard would now draw more scrutiny from regulators, journalists, and competitors. McNabb singled out complacency as the firm’s biggest threat and left his employees with seven words to remember—nuggets of wisdom from Presidents Harry Truman and Ronald Reagan, respectively: “The buck stops here.” And “Trust but verify.”

Merry Christmas, everyone.

Vanguard CEO Bill McNabb, photographed in the company’s headquarters in Malvern, Pa., admits to being a little “unsettled” by the asset manager’s stupendous growth.



Photograph by Nathaniel Welch

Six years on, Vanguard is still No. 1 in the mutual fund world—and by a widening margin. The company's pile of assets under management has more than doubled, to \$3.8 trillion, and it swells by roughly \$1 billion per day. Vanguard easily leads its peers in annual net asset flows, accounting for more than half of the industry total.

Vanguard's increasing dominance is multifaceted. The firm is now the biggest player in the booming area of target-date retirement funds. And today its ETF business has surpassed that of the industry pioneer, [State Street STT 0.93%](#), and trails only [BlackRock BLK 0.46%](#), the world's largest asset manager (thanks to its preeminent position with institutional investors). In part, Vanguard's success can be explained by the public's growing embrace of its specialty: indexing. But Vanguard's actively managed funds—now accounting for 30% of its assets—are growing too. The company's long-dormant international business has recently come alive as well, increasing in size by 66% since 2010, to \$234 billion in assets.

More recently Vanguard has been edging its way into the world of financial planning. Its new Vanguard Personal Advisor Services—low-cost financial guidance provided by an online “robo” platform and a pool of 450 human certified financial planners—launched in May 2015 and, with \$47 billion in assets, has easily surpassed trendy fintech startups like Betterment and Wealthfront.

Even as his company keeps finding new worlds to conquer, however, the chief architect of Vanguard's astounding run of growth remains circumspect about its consequences. McNabb admits that the need to bolster the company's workforce—hiring more than 1,700 people this year alone—has been a challenge. “I wouldn't want to kid you and say that it's easy,” he says. “It strains the organization.”

The CEO also admits that his company's sheer scale has foisted upon it a greater level of responsibility—one it perhaps wasn't fully prepared to handle a few years ago. Vanguard now owns about 5% of the average publicly traded company in the U.S. And advocacy groups have criticized the fund giant for not using its sway to, say, limit out-of-control CEO pay packages or support corporate political spending disclosures.

But embracing this new form of leadership will necessitate even more radical change. The Vanguard brand was built on the idea of relentlessly reducing the cost of investing for the average person—not on activism. Can Vanguard become an advocate for good governance without losing its way? “That is one of the biggest by-products of our success that needed to be addressed,” says McNabb. “We think of this as an incredible responsibility to get it right.”

It's a cool fall day on Vanguard's suburban campus, and McNabb is sucking on a lozenge. His voice is hoarse after racing in the Head of the Charles Regatta the previous weekend. Tall and still rail thin at 59, McNabb rowed crew at Dartmouth and coached the sport for a few years postcollege at a Pennsylvania prep school, where he also taught Latin. In conversation he comes across as relentlessly unimpressed with himself as the manager of so many trillions of dollars. “It's not my money,” he says. “We are very humbled to have the responsibility to oversee it.”

McNabb joined Vanguard in 1986. He had been to Wharton and done a stint at Chase Manhattan Bank in New York. At the time, Vanguard was merely a \$25 billion firm with a visionary founder and a 1-800 number. But McNabb liked its feel—“Wall Street smarts with Midwestern values”—and went through

25 interviews to get his first job there, including one with the visionary founder, himself: John “Jack” Bogle.

At the time, Bogle was recovering from one of his many heart attacks, and he grilled McNabb while stretched out on a couch: “I don’t know why you’d want to come here. We’re just a little company, and you’ve got a pretty impressive résumé.”

Vanguard has always been a different animal. Bogle founded the company in 1975 after being fired by the board of Wellington Management Co. He structured his new firm in a completely novel way—as a “mutual mutual fund,” or an investment company that would be owned by its member funds and operated wholly in the interest of its shareholders. It would run like a nonprofit, at cost; what wasn’t used to keep the lights on would be returned in the form of lower fees.

The company’s defining development came in 1976, when Bogle introduced Vanguard’s first index fund. It wasn’t an industry first—Wells Fargo [WFC -0.25%](#) beat him to it—but Bogle was a true believer in the concept: Over the long term you can’t beat the market; it’s better just to own a piece of every stock and save money on trading fees too.

The approach drew laughs. Fidelity publicly pooh-poohed it, and another competitor branded it “un-American.” When the fund launched, it was derided as “Bogle’s folly.”

Today it’s known as the Vanguard 500 Index Fund, and it holds some \$260 billion in assets. And Bogle himself retains a cultlike following of index-investing devotees who call themselves “Bogleheads.”

But the house that Bogle built is a very different place today. In fact, the 87-year-old founder, long since retired from the board, has made a sport of trolling management at the company he started. He hated the idea of exchange-traded funds when Vanguard got into the business in 2001 and still isn’t a big fan. Bogle has also joined in the criticism of institutional investors, like Vanguard, for not more aggressively throwing their weight around to advance shareholder interests.

Perhaps the greatest change, though, is in the firm’s basic orientation. “Under Jack Bogle, growth was a side effect,” says Daniel P. Wiener, a journalist-turned-financial-adviser who has published his popular subscription newsletter, *The Independent Adviser for Vanguard Investors*, for 26 years. “Today it’s an objective.”

Speaking at a Bogleheads convention in September in Philadelphia, Bogle said as much. He had always worried about growing too big, Bogle told the crowd. “It’s a greater responsibility and, for me, a constant worry.”

But Bogle also said the bad feelings between him and the stewards of his firm are behind him. His relationship with Vanguard management is as harmonious as it has ever been, he said before commending McNabb’s team for doing all it could to keep Vanguard “human.”

Collins also supplied McNabb and his team with a new vision of Vanguard. The company, he explained, was a “flywheel”—a concept that comes out of Collins’s decades of research on successful companies. Like a big, heavy wheel, Vanguard needed to be pushed forward until it picked up speed and began to

turn really fast. In the asset giant's case, low-cost funds with great long-term performance lead to loyalty and growth in assets—which leads to even lower costs and even more growth. In the cost-sensitive, postcrisis environment, Vanguard was ready to spin even faster.

“They had been building a flywheel,” says Collins. “They just didn’t have the language for it.”

To juice the flywheel's momentum, Vanguard has invested in ways it never had before. Its ETF business has increased sixfold, partly because the company took the unprecedented step of putting in place a nationwide sales force to strengthen its business with financial advisers.

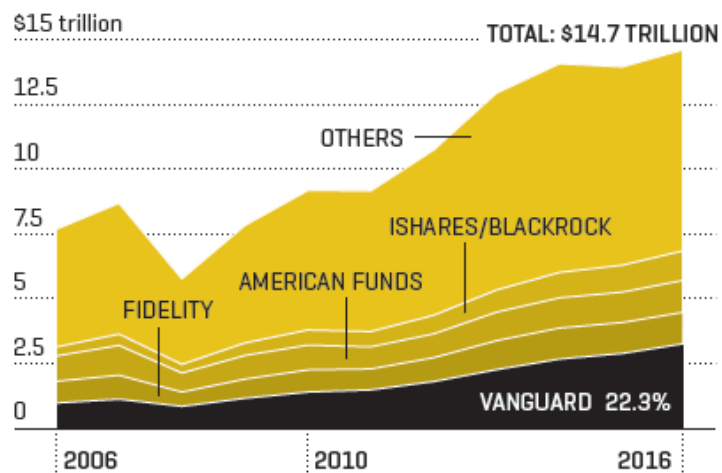
It's tempting to think of Vanguard's recent success as a rare, uncomplicated tale of moral triumph in the financial services industry. For once the nice guys finish first. Investors save. And we all win.

Of course, it's not that simple. Certainly the company's zeal for low fees has been good for investors. (The firm's downward pressure on costs is known as the “Vanguard effect.”) But the giant asset manager is showing signs of growing pains. Interviews with former employees and observers of the firm suggest a certain level of dysfunction at Vanguard—including technical glitches and low employee morale.

As a result, Vanguard's reputation has suffered in the world of online workplace rankings. On the job-search site Glassdoor, Vanguard has a 51% “recommend to a friend” rate, lower than the rate for some of its money-management peers, including Fidelity (81%), BlackRock (75%), and [TIAA](#) (69%).

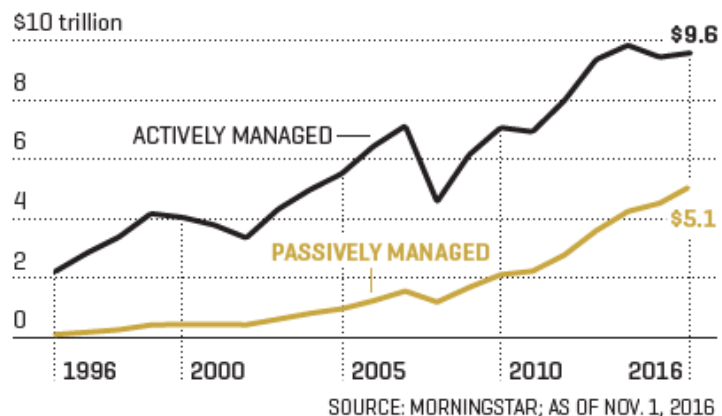
## TOTAL NET ASSETS

U.S., EXCLUDING MONEY MARKETS



One ill-fated episode was Vanguard's effort in 2013 to merge its clients' mutual fund and brokerage accounts. The company was flooded with calls from confused investors. And customer-service representatives often didn't have answers for them. Wiener, who writes the Vanguard newsletter, says the debacle was symptomatic of bigger problems. "The technology is just inadequate," he says, adding that one can't even deposit a check by smartphone on Vanguard's platform now—something that was previously possible on the site and that is standard across the industry. "You can't be a low-cost provider and not cut corners somewhere."

## TYPE OF MANAGEMENT



Former Vanguard employees say they often felt like the victims of corner-cutting. That's especially true at Vanguard's Scottsdale office—a site that employs more than 2,000 people, many of whom spend their days fielding customer calls. Some who answered phones said that understaffing meant they couldn't take days off and that they were monitored, to the minute, even for bathroom breaks.

Several former employees expressed concerns about metrics that were used to evaluate staff. One such measure, they say, was the number of account holders they enrolled for a consultation with Vanguard's Personal Advisor Services, the company's new advice product. The consultation was free, but former employees say many felt pressure to refer clients even if it wasn't a good fit. As a result, individuals with sophisticated portfolios, for instance, might be advised to move money into a handful of basic Vanguard index funds.

A Vanguard spokeswoman admits that the company hit "some bumps in the road" when adopting new technology in the past. But she disputes the notion that it has not invested sufficiently in tech. She cites numerous honors over the years from publications like *Computerworld* and *Information Week* as evidence that Vanguard's IT is "cutting edge."

As for complaints by former employees, Vanguard says it can't comment on specific accounts without all the details of the individual cases. But the spokeswoman cites the company's relatively low 9% turnover rate as evidence that morale is good. She says that employees are "not financially incented to push any products or services," and that the primary metric used for workers is "aligning investors or callers to

solutions.” She also points out that the advice product reflects Vanguard’s philosophy of broad, low-cost diversification.

Another lingering distraction is the allegation by a Vanguard tax-lawyer-turned-whistleblower, David Danon, that the firm’s structure has caused it to persistently evade taxes. According to his analysis, Vanguard should have been paying taxes on all the profits it returned to its shareholders in the form of lower fees. Danon’s initial complaint, filed in 2013 in New York State, was dismissed last year when a judge ruled that Danon had violated attorney-client privilege. The IRS is reportedly weighing his arguments but declined to comment. Vanguard says the charges are without merit.

Pressure has been mounting on Vanguard to speak up more on behalf of the 20 million shareholders it represents. In 2015, Vanguard’s corporate governance team cast 160,000 votes in 16,740 shareholder meetings in 73 countries. In 92% of cases they voted in support of management. Advocacy groups point out that the firm only rarely supports shareholder proposals on hot-button issues—for example, those related to managing climate risk.

Vanguard’s apparent support for the powers that be extends to compensation. According to an analysis from shareholder rights group [As You Sow](#), Vanguard and BlackRock were the most likely of the 25 largest mutual fund families to support pay packages of highly paid CEOs—each voting in favor 97% of the time, vs. 78% for the industry overall. Vanguard, though, says it prefers to address CEO pay by influencing board composition. In the past year, it voted against 396 directors in the U.S. who served on compensation committees.

McNabb says he thinks a lot about governance issues these days. He’s particularly concerned that companies not give in to “creeping short-termism” in their decisions. “People think that because we have a lot of indexed assets, we’ll be a passive owner,” says McNabb. “We don’t think that’s true. We want long-term results, not short-term.”

So Vanguard has beefed up “engagement” efforts—holding 817 meetings, phone calls, and videochats with companies in the past year compared with 685 the year before. Whereas a proxy vote is a shot fired, engagement is backdoor diplomacy. It’s Vanguard’s preferred approach, and the firm argues that it is more effective. Vanguard credits engagement with more than 100 “direct commitments to change” from companies this year. Commitments from whom, and about what exactly, it will not say.

McNabb is confident that Vanguard will find the right balance between its inherent low-key nature and its new high-profile role, just as he believes that the shift to Vanguard-style indexing is here to stay. But that doesn’t mean he’s relaxing. “If you’re not paranoid about success, you really run the risk of being